

operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§ 1.118-2 Contribution in aid of construction.

(a) *Special rule for water and sewerage disposal utilities*—(1) *In general.* For purposes of section 118, the term *contribution to the capital of the taxpayer* includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility that provides water or sewerage disposal services if—

(i) The amount is a contribution in aid of construction under paragraph (b) of this section;

(ii) In the case of a contribution of property other than water or sewerage disposal facilities, the amount satisfies the expenditure rule under paragraph (c) of this section; and

(iii) The amount (or any property acquired or constructed with the amount) is not included in the taxpayer's rate base for ratemaking purposes.

(2) *Definitions*—(i) *Regulated public utility* has the meaning given such term by section 7701(a)(33), except that such term does not include any utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(ii) *Water or sewerage disposal facility* is defined as tangible property described in section 1231(b) that is used predominately (80% or more) in the

trade or business of furnishing water or sewerage disposal services.

(b) *Contribution in aid of construction*—(1) *In general.* For purposes of section 118(c) and this section, the term *contribution in aid of construction* means any amount of money or other property contributed to a regulated public utility that provides water or sewerage disposal services to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility's water or sewerage disposal facilities.

(2) *Advances.* A contribution in aid of construction may include an amount of money or other property contributed to a regulated public utility for a water or sewerage disposal facility subject to a contingent obligation to repay the amount, in whole or in part, to the contributor (commonly referred to as an advance). For example, an amount received by a utility from a developer to construct a water facility pursuant to an agreement under which the utility will pay the developer a percentage of the receipts from the facility over a fixed period may constitute a contribution in aid of construction. Whether an advance is a contribution or a loan is determined under general principles of federal tax law based on all the facts and circumstances. For the treatment of any amount of a contribution in aid of construction that is repaid by the utility to the contributor, see paragraphs (c)(2)(ii) and (d)(2) of this section.

(3) *Customer connection fee*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, a customer connection fee is not a contribution in aid of construction under this paragraph (b) and generally is includible in income. The term *customer connection fee* includes any amount of money or other property transferred to the utility representing the cost of installing a connection or service line (including the cost of meters and piping) from the utility's main water or sewer lines to the line owned by the customer or potential customer. A customer connection fee also includes any amount paid as a service charge for starting or stopping service.

(ii) *Exceptions*—(A) *Multiple customers.* Money or other property contributed

for a connection or service line from the utility's main line to the customer's or the potential customer's line is not a customer connection fee if the connection or service line serves, or is designed to serve, more than one customer. For example, a contribution for a split service line that is designed to serve two customers is not a customer connection fee. On the other hand, if a water or sewerage disposal utility treats an apartment or office building as one utility customer, then the cost of installing a connection or service line from the utility's main water or sewer lines serving that single customer is a customer connection fee.

(B) *Fire protection services.* Money or other property contributed for public and private fire protection services is not a customer connection fee.

(4) *Reimbursement for a facility previously placed in service—(i) In general.* If a water or sewerage disposal facility is placed in service by the utility before an amount is contributed to the utility, the contribution is not a contribution in aid of construction under this paragraph (b) with respect to the cost of the facility unless, no later than 8½ months after the close of the taxable year in which the facility was placed in service, there is an agreement, binding under local law, that the utility is to receive the amount as reimbursement for the cost of acquiring or constructing the facility. An order or tariff, binding under local law, that is issued or approved by the applicable public utility commission requiring current or prospective utility customers to reimburse the utility for the cost of acquiring or constructing the facility, is a binding agreement for purposes of the preceding sentence. If an agreement exists, the basis of the facility must be reduced by the amount of the expected contributions. Appropriate adjustments must be made if actual contributions differ from expected contributions.

(ii) *Example.* The application of paragraph (b)(4)(i) of this section is illustrated by the following example:

Example. M, a calendar year regulated public utility that provides water services, spent \$1,000,000 for the construction of a water facility that can serve 200 customers. M placed the facility in service in 2000. In June 2001,

the public utility commission that regulates M approves a tariff requiring new customers to reimburse M for the cost of constructing the facility by paying a service availability charge of \$5,000 per lot. Pursuant to the tariff, M expects to receive reimbursements for the cost of the facility of \$100,000 per year for the years 2001 through 2010. The reimbursements are contributions in aid of construction under paragraph (b) of this section because no later than 8½ months after the close of the taxable year in which the facility was placed in service there was a tariff, binding under local law, approved by the public utility commission requiring new customers to reimburse the utility for the cost of constructing the facility. The basis of the \$1,000,000 facility is zero because the expected contributions equal the cost of the facility.

(5) *Classification by ratemaking authority.* The fact that the applicable rate-making authority classifies any money or other property received by a utility as a contribution in aid of construction is not conclusive as to its treatment under this paragraph (b).

(c) *Expenditure rule—(1) In general.* An amount satisfies the expenditure rule of section 118(c)(2) if the amount is expended for the acquisition or construction of property described in section 118(c)(2)(A), the amount is paid or incurred before the end of the second taxable year after the taxable year in which the amount was received as required by section 118(c)(2)(B), and accurate records are kept of contributions and expenditures as provided in section 118(c)(2)(C).

(2) *Excess amount—(i) Includible in the utility's income.* An amount received by a utility as a contribution in aid of construction that is not expended for the acquisition or construction of water or sewerage disposal facilities as required by paragraph (c)(1) of this section (the excess amount) is not a contribution to the capital of the taxpayer under paragraph (a) of this section. Except as provided in paragraph (c)(2)(ii) of this section, such excess amount is includible in the utility's income in the taxable year in which the amount was received.

(ii) *Repayment of excess amount.* If the excess amount described in paragraph (c)(2)(i) of this section is repaid, in whole or in part, either—

(A) Before the end of the time period described in paragraph (c)(1) of this

section, the repayment amount is not includible in the utility's income; or

(B) After the end of the time period described in paragraph (c)(1) of this section, the repayment amount may be deducted by the utility in the taxable year in which it is paid or incurred to the extent such amount was included in income.

(3) *Example.* The application of this paragraph (c) is illustrated by the following example:

Example. M, a calendar year regulated public utility that provides water services, received a \$1,000,000 contribution in aid of construction in 2000 for the purpose of constructing a water facility. To the extent that the \$1,000,000 exceeded the actual cost of the facility, the contribution was subject to being returned. In 2001, M built the facility at a cost of \$700,000 and returned \$200,000 to the contributor. As of the end of 2002, M had not returned the remaining \$100,000. Assuming accurate records are kept, the requirement under section 118(c)(2) is satisfied for \$700,000 of the contribution. Because \$200,000 of the contribution was returned within the time period during which qualifying expenditures could be made, this amount is not includible in M's income. However, the remaining \$100,000 is includible in M's income for its 2000 taxable year (the taxable year in which the amount was received) because the amount was neither spent nor repaid during the prescribed time period. To the extent M repays the remaining \$100,000 after year 2002, M would be entitled to a deduction in the year such repayment is paid or incurred.

(d) *Adjusted basis*—(1) *Exclusion from basis.* Except for a repayment described in paragraph (d)(2) of this section, to the extent that a water or sewerage disposal facility is acquired or constructed with an amount received as a contribution to the capital of the taxpayer under paragraph (a) of this section, the basis of the facility is reduced by the amount of the contribution. To the extent the water or sewerage disposal facility is acquired as a contribution to the capital of the taxpayer under paragraph (a) of this section, the basis of the contributed facility is zero.

(2) *Repayment of contribution.* If a contribution to the capital of the taxpayer under paragraph (a) of this section is repaid to the contributor, either in whole or in part, then the repayment amount is a capital expenditure in the taxable year in which it is paid or incurred, resulting in an increase in the

property's adjusted basis in such year. Capital expenditures allocated to depreciable property under paragraph (d)(3) of this section may be depreciated over the remaining recovery period for that property.

(3) *Allocation of contributions.* An amount treated as a capital expenditure under this paragraph (d) is to be allocated proportionately to the adjusted basis of each property acquired or constructed with the contribution based on the relative cost of such property.

(4) *Example.* The application of this paragraph (d) is illustrated by the following example:

Example. A, a calendar year regulated public utility that provides water services, received a \$1,000,000 contribution in aid of construction in 2000 as an advance from B, a developer, for the purpose of constructing a water facility. To the extent that the \$1,000,000 exceeds the actual cost of the facility, the contribution is subject to being returned. Under the terms of the advance, A agrees to pay to B a percentage of the receipts from the facility over a fixed period, but limited to the cost of the facility. In 2001, A builds the facility at a cost of \$700,000 and returns \$300,000 to B. In 2002, A pays \$20,000 to B out of the receipts from the facility. Assuming accurate records are kept, the \$700,000 advance is a contribution to the capital of A under paragraph (a) of this section and is excludable from A's income. The basis of the \$700,000 facility constructed with this contribution to capital is zero. The \$300,000 excess amount is not a contribution to the capital of A under paragraph (a) of this section because it does not meet the expenditure rule described in paragraph (c)(1) of this section. However, this excess amount is not includible in A's income pursuant to paragraph (c)(2)(ii) of this section since the amount is repaid to B within the required time period. The repayment of the \$300,000 excess amount to B in 2001 is not treated as a capital expenditure by A. The \$20,000 payment to B in 2002 is treated as a capital expenditure by A in 2002 resulting in an increase in the adjusted basis of the water facility from zero to \$20,000.

(e) *Statute of limitations*—(1) *Extension of statute of limitations.* Under section 118(d)(1), the statutory period for assessment of any deficiency attributable to a contribution to capital under paragraph (a) of this section does not expire before the expiration of 3 years after

the date the taxpayer notifies the Secretary in the time and manner prescribed in paragraph (e)(2) of this section.

(2) *Time and manner of notification.* Notification is made by attaching a statement to the taxpayer's federal income tax return for the taxable year in which any of the reportable items in paragraphs (e)(2)(i) through (iii) of this section occur. The statement must contain the taxpayer's name, address, employer identification number, taxable year, and the following information with respect to contributions of property other than water or sewerage disposal facilities that are subject to the expenditure rule described in paragraph (c) of this section—

(i) The amount of contributions in aid of construction expended during the taxable year for property described in section 118(c)(2)(A) (qualified property) as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received;

(ii) The amount of contributions in aid of construction that the taxpayer does not intend to expend for qualified property as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received; and

(iii) The amount of contributions in aid of construction that the taxpayer failed to expend for qualified property as required under paragraph (c)(1) of this section, identified by taxable year in which the contributions were received.

(f) *Effective date.* This section is applicable for any money or other property received by a regulated public utility that provides water or sewerage disposal services on or after January 11, 2001.

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§ 1.119-1 Meals and lodging furnished for the convenience of the employer.

(a) *Meals—(1) In general.* The value of meals furnished to an employee by his employer shall be excluded from the employee's gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the

convenience of the employer. The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case. If the tests described in subdivisions (i) and (ii) of this subparagraph are met, the exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation.

(2) *Meals furnished without a charge.*

(i) Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a substantial noncompensatory business reason of the employer. If an employer furnishes meals as a means of providing additional compensation to his employee (and not for a substantial noncompensatory business reason of the employer), the meals so furnished will not be regarded as furnished for the convenience of the employer. Conversely, if the employer furnishes meals to his employee for a substantial noncompensatory business reason, the meals so furnished will be regarded as furnished for the convenience of the employer, even though such meals are also furnished for a compensatory reason. In determining the reason of an employer for furnishing meals, the mere declaration that meals are furnished for a noncompensatory business reason is not sufficient to prove that meals are furnished for the convenience of the employer, but such determination will be based upon an examination of all the surrounding facts and circumstances. In subdivision (ii) of this subparagraph, there are set forth some of the substantial noncompensatory business reasons which occur frequently and which justify the conclusion that meals furnished for such a reason are furnished for the convenience of the employer. In subdivision (iii) of this subparagraph, there are set forth some of the business reasons which are considered to be compensatory and which, in the absence of a substantial noncompensatory business reason, justify the conclusion that meals furnished for such a reason are not furnished for the convenience of the employer. Generally,